INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statutes and regulations involved	2
Statement	2
Argument	5
Conclusion	8
Appendix	9

CITATIONS

Cases:	
Aluminum Company of America v. *United States*, 67 F (2d) 172, certiorari denied, 291 U. S. 666	7
Lucas v. *Structural Steel Co.*, 281 U. S. 264	7
Old Mission Co. v. *Helvering*, 293 U. S. 289	7
Statutes:	
Revenue Act of 1928, c. 852, 45 Stat. 791:	
Sec. 113	12
Sec. 141	5
Revenue Act of 1932, c. 209, 47 Stat. 169:	
Sec. 22	9
Sec. 113	6, 9
Sec. 141	5, 7, 10
Revenue Act of 1934, c. 277, 48 Stat. 680:	
Sec. 22	12
Sec. 113	5, 6, 12
Sec. 141	5, 12
Miscellaneous:	
Treasury Regulations 75, Art. 39	5, 15
Treasury Regulations 78:	
Art. 12	13
Art. 31	6, 14
Art. 39	6, 15
Treasury Regulations 86, Art. 113 (a) (11)–1	5, 15
Treasury Regulations 89, Art. 39	15
Treasury Regulations 104, Sec. 23.39	8, 17

In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 879

MAGNOLIA PETROLEUM COMPANY, PETITIONER

v.

W. A. THOMAS, COLLECTOR OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The oral opinion of the District Court is not reported but appears at R. 24–25. The opinion of the Circuit Court of Appeals (R. 31–35) is reported at 151 F. (2d) 1008.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered December 4, 1945. (R. 35.) The petition for a writ of certiorari was filed February 21, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the courts below erred in sustaining the validity of the Treasury Regulation which requires that where a corporate taxpayer was a member of an affiliated group which filed a consolidated return, and in the succeeding taxable year makes a separate return, the value of its opening inventory for computing its net income for the succeeding year shall be the proper value of its closing inventory used in computing consolidated net income for the preceding year.

STATUTES AND REGULATIONS INVOLVED

The pertinent statutes and regulations are set forth in the Appendix, *infra*, pp. 9–18.

STATEMENT

The taxpayer is a Texas corporation engaged in producing, refining and marketing crude oil and the products thereof. (R. 13, 14.) The taxpayer is one of a group of affiliated corporations consisting of Socony-Vacuum Oil Company and its affiliated subsidiaries, and the taxpayer owns all of the capital stock of Magnolia Pipe Line Company, which transports most of the taxpayer's products from its wells to its refineries and in some cases to market. (R. 14.) The taxpayer acquires some of its products from Vacuum Oil Company, Inc., an affiliated company. (R. 15.)

Magnolia Pipe Line Company makes a charge against the taxpayer, in accordance with appro-

priate tariffs, for transporting the taxpayer's products. These charges are entered upon the books of both corporations and settlement is actually made between them. (R. 14.)

For the year 1933 the taxpayer and its affiliates filed a consolidated income tax return under the provisions of law then in force. In accordance with the applicable law and regulations the taxpayer, in computing its inventory of products on hand, did not include transportation costs for those products paid by the taxpayer to Magnolia Pipe Line Company, except to the extent of the cost to Magnolia Pipe Line Company of such transportation; and the inventory products acquired by the taxpayer from Vacuum Oil Company, Inc., were valued at the cost of the products to Vacuum Oil Company, Inc., rather than their cost to the taxpayer. (R. 14–15.) In short, taxpayer's inventory was computed by eliminating as an item of cost the profits to the taxpayer's affiliates.

The Revenue Act of 1934 withdrew from this group the privilege of filing consolidated returns. Accordingly, for the year 1934 the taxpayer filed a separate return. (R. 14–15.) In computing its opening and closing inventory for that return the taxpayer included in the costs of its products the cost to it of transporting the products included in its inventory, that is, the amount paid to Magnolia Pipe Line Company for such transportation; and the taxpayer valued the cost of the products

acquired from Vacuum Oil Company, Inc., at their cost to taxpayer rather than their cost to Vacuum. (R. 15.) In its separate return for 1935 the taxpayer valued its inventories on the same basis as for 1934. (R. 15–16.)

The Commissioner adjusted the taxpayer's opening inventory for 1934 to correspond to the closing inventory for 1933 as it was reported upon the affiliated basis, thereby decreasing the opening inventory for 1934 as valued by the taxpayer, in the amount of $2,536,328.31. He also decreased the closing inventory as of December 31, 1934, by $344,314.48, to bring the cost of products then remaining from the December 31, 1933, inventory to the same affiliated cost basis. These changes resulted in a total addition of $2,192,013.83 to the taxpayer's income for the year 1934. The Commissioner also adjusted the opening inventory for 1935 to correspond to the figure fixed by him as the closing inventory for 1934. (R. 16–17.)

The additional income taxes assessed against the taxpayer for 1934 and 1935, based upon these adjustments, were duly paid by the taxpayer, and the Commissioner denied taxpayer's claims for refund. (R. 17.) The only question in the case is the method of computing the cost of those products in the taxpayer's inventory which the taxpayer had on hand at the opening of 1934, immediately after the taxpayer ceased reporting its income on the affiliated basis, and which remained in taxpayer's inventory through the opening of

1935. (Pet. 4.) The District Court held that the taxpayer is not entitled to recover. (R. 25.) The Circuit Court of Appeals affirmed. (R. 35.)

ARGUMENT

The taxpayer's attack (Pet. 5) upon Treasury Regulations 86, Article 113 (a) (11)–1 (Appendix, *infra,* pp. 15–16), is unjustified. That provision, squarely applicable here, directs that if a corporation has been a member of an affiliated group which has made a consolidated return for 1933, and is required to make a separate return for 1934 and succeeding years, the value of the opening inventory for computing the corporation's net income for 1934 is the proper value of the closing inventory used in computing the consolidated net income for the preceding year. That provision was promulgated under the Revenue Act of 1934, Section 113 (a) (11) (Appendix, *infra,* pp. 12–13), which provides that the cost basis in case of property acquired by a corporation during 1929 or any subsequent year in respect of which a consolidated return is made shall be determined in accordance with regulations prescribed under Section 141 (b) of the Revenue Act of 1928, 1932 or 1934 (Appendix, *infra,* pp. 11, 12). The rule prescribed in the regulation under attack is the same as the rule which was prescribed under the Revenue Acts of 1928 and 1932, in Treasury Regulations 75 and in Treasury Regulations 78. Those Regulations provided

in Article 39 (b) (Appendix, *infra,* p. 15) that if a corporation has been a member of an affiliated group which has filed a consolidated return and in the succeeding taxable year files a separate return, the value of the opening inventory for computing its net income for the succeeding, separate return year shall be the proper value of the closing inventory used in computing consolidated net income for the preceding year. As the court below held (R. 34), the express reference in the 1934 Act to those regulations excludes the contention (Pet. 5) that this same rule, promulgated under the 1934 Act and governing in this case, is without basis in the Revenue Act of 1934.

The taxpayer claims the right to substitute its own method of computation for the method prescribed by the Treasury Regulations and approved by the Revenue Act of 1934, asserting that its own method would more truly reflect the income of the taxpayer itself (Br. 11–21) and would leave untaxed those intercompany profits which previously went unrecognized (Treasury Regulations 78, Art. 31 (a), Appendix, *infra,* p. 14) by virtue of the taxpayer's privilege prior to 1934 of joining in consolidated returns (Br. 21–26). The claim overlooks the general rule that the cost basis of property which should have been included in the last inventory shall be the last inventory value thereof. (Revenue Acts of 1932 and 1934, Sec. 113 (a) (1), Appendix, *infra,* pp. 9, 12.) It

assumes, erroneously, that in speaking of "last inventory value" the statute means something other than the last inventory value used by the taxpayer when it invoked the privilege of joining in a consolidated return. (Br. 17.) Moreover, it assumes that under Section 141 of the Revenue Act of 1932, permitting consolidated returns, all of the profits which went unrecognized during the affiliated return period should necessarily go forever untaxed. Any such assumption is erroneous, for Section 141 (b) gave to the Commissioner a broad discretion to adopt any regulation he may deem necessary for determining and computing the taxes due where consolidated returns were made,

> * * * in order that the tax liability of an affiliated group * * * and of each corporation * * *, both during *and* after the period of affiliation, may be determined * * * in such manner as clearly to reflect the income and to prevent avoidance of tax liability. [Italics supplied.]

The controlling regulation is clearly within the power granted. *Lucas* v. *Structural Steel Co.*, 281 U. S. 264; *Old Mission Co.* v. *Helvering*, 293 U. S. 289.

The case of *Aluminum Company of America* v. *United States*, 67 F. (2d) 172 (C. C. A. 3d), certiorari denied, 291 U. S. 666, stated by the taxpayer to be inconsistent with the Commissioner's

action here (Br. 23) arose under the Revenue Act of 1918, the provisions of which were wholly different from those at bar. Section 23.39 of Treasury Regulations 104 (Appendix, *infra*, pp. 17–18) gives no support to the taxpayer's position. (Br. 23–24.) For years prior to January 1, 1941, those Regulations prescribe the same rule applied by the Commissioner here; and for subsequent years they prescribe a different rule from the one for which the taxpayer contends.

CONCLUSION

The petition presents no substantial question and should be denied.

Respectfully submitted.

J. HOWARD MCGRATH,
Solicitor General.

SEWALL KEY,
Acting Assistant Attorney General.
J. LOUIS MONARCH,
WILLIAM ROBERT KOERNER,
Special Assistants to the Attorney General.

MARCH 1946.